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IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

LEASEWAY TRANSPORTATION CORP. and
RAYMOND J. REHOR,

Petitioners,

v.

UNITED STATES OF AMERICA and
JAMES SIMEO,

Respondents.

BRIEF *AMICUS CURIAE* OF PICKANDS MATHER & CO. IN SUPPORT OF PETITION OF LEASEWAY TRANSPORTATION CORP. and RAYMOND J. REHOR FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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This brief in support of Petitioners' Petition for a Writ of Certiorari is submitted with the written consent of counsel for all parties, copies of which have been filed with the Clerk of the Court.

INTEREST OF THE AMICUS CURIAE

Amicus Curiae Pickands Mather & Co. ("PM") is a Delaware corporation engaged in the businesses of iron ore and coal mining and bulk transportation. Its federal income tax return is filed as part of a consolidated return with its parent corporation, Moore McCormack Resources, Inc. ("MMR"), which is also a Delaware corporation, and whose shares are publicly held.

PM has a full-time Internal Audit Department that regularly and routinely performs the kinds of work listed in footnote 4 of the Petition for a Writ of Certiorari of Leaseway Transportation Corp. ("Leaseway"). Reports to management are prepared by personnel of that department who review its work, summarize its findings and list recommendations for action, where appropriate. Accordingly, PM has an interest in the outcome of this litigation.

SUMMARY OF ARGUMENT

1. Confidentiality of Internal Audit Reports ("IARs") is critical to the effective performance of the internal audit function and hence to compliance with the law by business.

2. The source data reviewed by internal auditors in the performance of their work is readily available to the Internal Revenue Service ("IRS") which under its regular audit procedures has full access to a taxpayer's employees and records to carry out its audit. Accordingly, the IRS has no need for access to the internal auditors' workpapers or thought processes through the examination of IARs.

3. The IRS should be held to a reasonable standard of relevance in order to obtain IARs in the course of an audit. The IRS should show a realistic expectation that the IARs are relevant to the audit before the IARs are made available to it.

ARGUMENT

I. CONFIDENTIALITY IS ESSENTIAL TO CONTINUED VITALITY OF INTERNAL AUDIT REPORT PROCEDURE.

As pointed out by Leaseway in its Petition for a Writ of Certiorari (p.6, footnote 4), internal auditors concern themselves with the "policies, operational approaches, utilization of resources, manpower performance and results achieved," and "evaluate controls, check compliance with policies and procedures, and test reporting systems in the nonfinancial areas of corporations as well as in the financial." In the course of performing these duties on behalf of their employers, internal auditors routinely review books, records, and other source data of the employer and also interrogate and review with other corporate employees compliance with their employer's requirements addressing these significant business concerns.

In furtherance of their duties, the internal auditors make notes of interviews with

other employees for purposes of preparing reports to corporate management of their findings and recommendations. IARs are frequently informative about the quality of internal control programs and the level of compliance with such programs by corporate employees. In many instances these reports bypass management and are made directly to the employers' Boards of Directors. Thereafter these reports are utilized by management or audit committees of Boards to determine operational efficiency.

Corporate compliance with the law is enhanced when internal auditors are free to make inquiries of other employees of the corporation to whatever extent is appropriate in evaluating compliance with company policies and procedures, to record such conversations and to report candidly to management.

A critical function of that freedom is the candor with which other corporate employees will conduct these discussions. If

there is a concern that matters discussed are subject to third party disclosure full candor will inevitably be discouraged, if not shut off. Disclosure would be discouraged in the same manner that candid responses to the questionnaires developed by the general counsel for Upjohn Co. (in connection with that corporation's investigation of so-called "sensitive payments") would have been less likely if those employees did not believe their disclosures would be treated as "highly confidential." Upjohn Co. v. United States, 449 U.S. 383, 387 (1981). In its opinion in that case, this Court stated:

> Consistent with the underlying purposes of the attorney-client privilege, these communications must be protected against compelled disclosure.

449 U.S. at 395.

II. INTERNAL AUDIT REPORTS SHOULD NOT BE SUBJECT TO AN IRS SUMMONS SINCE THE INFORMATION AND DATA THEY CONTAIN ARE OTHERWISE AVAILABLE TO THE IRS.

The test for disclosure by IRS summons provided by this Court in United States v. Powell, 379 U.S. 48, 57-58 (1964) requires that before an IRS summons may be issued requesting information or data of a taxpayer, the information or data must not otherwise be available to IRS. This requirement effectively eliminates duplication of effort and expense for the taxpayer and it allows the IRS to receive information not already in its possession. As noted by the Second Circuit Court in United States v. Arthur Young & Co.:

> The corporation's own books and the audit workpapers furnish the IRS with all the raw data that it needs to calculate the taxpayer's tax liability. A roadmap would merely save the IRS some time in finding the best arguments for asserting a deficiency.

677 F.2d 211, 220 (2d Cir. 1982), cert. granted, 51 U.S.L.W. 3611 (U.S. Feb. 22, 1983) (No. 82-687).

All of the books, records, and other data used by internal auditors in the performance of their duties and all of the employees interrogated by them are readily accessible to the IRS. No claim is made that the protection of the IAPs sought by Leaseway extends to these other sources of information and data. Thus, pursuant to the third requirement of Powell, IAPs should not be within the scope of an IRS summons.

III. IF INTERNAL AUDIT REPORTS ARE TO BE SUBJECT TO AN IRS SUMMONS, THE IPS SHOULD HAVE A REALISTIC EXPECTATION THAT THE REPORTS WILL BE RELEVANT TO THE TAX AUDIT.

The test for disclosure by IRS summons in Powell also provides that the information sought must be relevant to the tax audit. 379 U.S. at 57. This Court, however, has not formulated the degree of relevance necessary to enforce a summons under this requirement. In the absence of an articulated standard from this Court, the lower courts have applied conflicting approaches to the relevance test.

Many courts have said that the summons must seek information that "might throw light upon the correctness of the taxpayer's return." E.g., United States v. Turner, 480 F.2d 272, 279 (7th Cir. 1973); United States v. Egenberg, 443 F.2d 512 (3d Cir. 1971); United States v. Wyatt, 637 F.2d 293 (5th Cir. 1981). However, many other courts have refined this standard by requiring, as a precondition to summons enforcement, that the IRS show "a realistic expectation rather than an idle hope that something may be discovered." E.g., United States v. Matras, 487 F.2d 1271, 1274 (8th Cir. 1973); United States v. Harrington, 388 F.2d 520 (2d Cir. 1968).

This Court should resolve the conflict in the lower courts and apply the more reasonable "realistic expectation" standard. The more stringent standard is especially appropriate in view of the strong public policy which supports the need for confidentiality of IARs. If this Court does not

apply the more reasonable standard, the administrative convenience of the IRS will prevail and IARs will routinely be within the IRS summons power. In such a scenario, as stated by the court in Matras:

> ...it is difficult to imagine corporate materials that might not contribute to a more comprehensive understanding of the workings of the corporation and thus, according to the government, be deemed relevant to the tax investigation.

487 F.2d at 1275.

Such a broad standard of relevance would inevitably impair the effectiveness of the internal audit function of corporations, such as the Amicus Curiae. Accordingly, the benefits of encouraging operational efficiency and enhancing compliance with the law would be lost. It is thus necessary that this Court moderate the IRS summons power to restrict access to IARs to those situations where the IRS shows that it has a clear need for the information and a realistic expectation that they are relevant to the tax audit.

The well established procedure of in camera review of documents, such as IARs, by the trial court should be used to apply this standard. See, e.g., United States v. Noall, 587 F.2d 123 (2d Cir. 1978). The IARs could be reviewed in chambers by the trial judge, his clerks or a special magistrate to ensure that the IRS only obtain those IARs for which it has a need and realistic expectation of relevance.

CONCLUSION

Amicus Curiae respectfully submits that Leaseway's Petition for a Writ of Certiorari should be granted to afford this Court the opportunity to consider whether IARs are within IRS summons power. Amicus Curiae believes IRS should not have access to IARs because:

1. Confidentiality of internal audit reports is crucial to the effective performance of the internal audit function of a business, and is therefore crucial in the ordinary and regular audit procedure to encourage full compliance with the law.

2. The underlying source data and the testimony of the taxpayer's employees are available to the IRS under the Powell test.

3. Unless the IRS is held to the standard of having a realistic expectation of relevance based upon a showing of need, the benefits presently derived from the internal audit report procedure will no longer be enjoyed.

Respectfully submitted,

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